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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

RAYMOND L. DIRKS,

Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

PETITIONER'S REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

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Petitioner's Reply Brief In Support Of Petition For Writ Of Certiorari To The United States Court Of Appeals For The District Of Columbia Circuit

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1. The Solicitor General Agrees with Petitioner that the Decisions Below Are Wrong and Will Have an Adverse Effect on Federal Criminal Law Enforcement

It is undisputed that Petitioner Dirks, following up unverified allegations of a former employee, uncovered and helped make public a massive fraud at Equity Funding Corporation of America. As a result, twenty-two participants in the fraud were convicted of federal crimes and received sentences ranging up to eight years in jail, along with substantial fines. It is equally undisputed that a somnolent SEC had failed to uncover the fraud despite being given essentially the same leads as Dirks on several different occasions (once by a former member of its own staff) over a period of years.

The SEC's response to all this, approved by the Court of Appeals for the District of Columbia Circuit, was to sue

Dirks because some of the persons to whom he disclosed his ongoing investigation as he tried to publicize the allegations traded in Equity Funding stock.

Petitioner Dirks has set forth in his Petition for Writ of Certiorari the reasons why the decision of the Court of Appeals for the District of Columbia Circuit in this case raises issues of great importance to the proper functioning of the securities industry and to law enforcement, and conflicts with this Court's decision in *Chiarella* v. *United States*, 445 U.S. 222 (1980). The Solicitor General agrees with Petitioner.

Indeed, the most significant aspect of the brief filed by the Securities and Exchange Commission in Opposition to the Petition herein is that the Solicitor General not only has refused to sign the brief but has also taken the extraordinary step of stating that:

> "The Solicitor General is of the view that the holding of the court of appeals is in conflict with this Court's decision in *Chiarella* v. *United States*, 445 U.S. 222 (1980). The information about the ongoing criminal scheme, obtained by a former employee of Equity Funding and passed on to petitioner Dirks, was not 'inside' information or any other form of 'confidential' information. See *Roberts* v. *United States*, 445 U.S. 552, 557-558 (1980); compare *Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961). Petitioner Dirks was not under a duty to disclose that information before trading with it or passing it on. He was subject to no fiduciary relationship with other traders (*Chiarella* v. *United States, supra*, 445 U.S. at 228), there was no element of misappropriation or other misconduct in obtaining or transmitting the information (*id.* at 239-245) (Burger, C.J., dissenting), and the information was 'legally available to others' through the exercise of 'diligence or acumen' (*id.* at 251-252 & n.2) (Blackmun, J., dissenting). In these circumstances, there is no basis for viewing petitioner's conduct as

> fraudulent under the federal securities laws. The Solicitor General also is of the view that the decisions of the SEC and the court of appeals have a potential adverse effect on federal criminal law enforcement." (Opp. Br. at 17-18 n.*.)

The views of the Solicitor General that the position of the SEC and the decision below are not only wrong and inconsistent with this Court's ruling, but are potentially harmful to federal criminal law enforcement, amply demonstrate that this case should be reviewed by the Court.

2. The Decision of the Court Below Conflicts with the Decisions of This Court in *Chiarella* and of the Second Circuit

The SEC insists that the decision below does not conflict with this Court's decision in *Chiarella*. (Opp. Br. at 13) Yet the Solicitor General states in no uncertain terms that the D.C. Circuit decision conflicts not only with the majority opinion in *Chiarella*, but with the concurring and dissenting opinions in that case as well. (Opp. Br. at 17 n.*)

It is apparent that the holding below that Dirks acquired fiduciary duties to disclose or abstain when he legitimately acquired information and investigated allegations about corporate fraud constitutes a complete evisceration of *Chiarella* which should not be allowed to go unchecked. As Professor Easterbrook, commenting on this case, has observed, "when the release of information was not wrongful—and certainly the former employees of Equity Funding did no wrong in telling Dirks about the fraud—there is no justification for barring the use of the information." Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 S. Ct. Rev. 309, 338. Or to quote the Solicitor General, "in these circumstances there is no

basis for viewing petitioner's conduct as fraudulent under the federal securities laws." (Opp. Br. at 18 n.*)

Nor could there be a clearer conflict than that between the decision below and the Second Circuit's decision in *Walton* v. *Morgan Stanley & Co.*, 623 F.2d 796 (2d Cir. 1980). In *Walton*, the Second Circuit found that the investment banking firm breached no duty to a company that was not a client when it traded on inside information of that company.[1] Yet the D.C. Circuit has held that an employee of a broker-dealer has a special "ethical" duty "to the Commission and to the public" to disclose inside information or abstain from trading. (Opp. Br. at 16)

Finally, the SEC in effect suggests that this Court, future litigants, and—most importantly—all employees of broker-dealers should simply forget the Court of Appeals' novel imposition of this "ethical duty" as a legal requirement. But the judgment and opinion of the Court of Appeals cannot so easily be ignored. That decision will at a minimum be viewed as the law in the District of Columbia Circuit. Moreover, the SEC, having prevailed

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[1] Although the SEC seeks to distinguish *Walton* on the ground that it was a state law case, the Second Circuit expressly noted that the type of duty at issue was precisely the type of duty required under *Chiarella*. For this reason, *Walton* has been viewed as being in direct conflict with this case. *See* Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 Cal. L. Rev. 1, 30-32 (1982). It is worth noting in this context that the SEC's citation of *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974) (Opp. Br. at 15) does nothing to minimize the conflict between the Second and D.C. Circuits. In *Shapiro*, the underwriter had a fiduciary duty to its client company, as the SEC itself found in a related proceeding, and breached that duty in disclosing inside information of the company to its customers. *See also In re Investors Management Co.*, 44 S.E.C. 633, 645 (1971).

below, can be fully expected to use the case as a justification for its own nationwide prosecutorial decisions. Accordingly, if allowed to stand, the case will have mischievous effects upon the securities industry for years to come.

3. This Is an Important Case with Far-reaching Consequences for the Securities Industry and Federal Law Enforcement, and Should Be Reviewed

In light of the clear conflict with *Chiarella* and with the Second Circuit, the SEC is compelled to rely primarily upon the argument that this is a "once-in-a-lifetime" case which does not involve the sort of "routine research" that securities analysts engage in, and therefore does not warrant review. (Opp. Br. at 9)[2] The information that

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[2] It should be noted that the SEC's arguments on "materiality" (Opp. Br. at 10-13) fail to address squarely the question whether unverified allegations of fraud vigorously denied by management—some of which turn out to be true and some of which do not—are nonetheless material "facts" under the securities laws. *See* Petition at 21-25.

The SEC also grossly misstates the findings below. For example, the SEC incorrectly states that Dirks conveyed only a "soft" story about accounting irregularities to those who he determined did not own Equity Funding securities. (Opp. Br. at 4 & n.6) There is no support at all in the record for this. The Administrative Law Judge did not find that Dirks told a "soft" story to Fidelity Management and Research on March 26. In fact the testimony was undisputed that Dirks told them nothing at all about Equity Funding, because they expressed no interest in the company and could not be expected to follow up on the allegations. (*In re Boston Company Institutional Investors, Inc.*, slip opinion, at 101; [1978] Fed. Sec. L. Rep. (CCH) ¶ 81,705, at 80,845.) The only instance where the Administrative Law Judge found that Dirks conveyed a "soft" story involved a

Dirks received about a fraud of perhaps unparalleled magnitude may not have been "routine," but as the testimony made clear, receipt of this type of allegation is far from uncommon. (J.A. 940-41; R. 4507, 4509, 8680-81) On the contrary, because it is logical for an employee with such information to turn to an analyst who has been following an industry and who is known within that industry, securities analysts all too frequently receive information from corporate employees about criminal, or at least questionable, corporate activities.

For this reason, the community of analysts has certainly not viewed Dirks' situation as unique. Indeed, when the SEC proceeding was initiated against Dirks, the general counsel of the Financial Analysts Federation stated that the case "will have important ramifications relating to analysts' duties and responsibilities and the legal framework in which they are to carry out their professional occupation." Gillis, *Securities Law and Regulation—Equity Funding Revisited*, Fin. Analysts J. 10, 11 (March-April 1977). He went on to note that "[t]he 'bottom line' for analysts, is, of course, the legal and practical impact of the Equity Funding litigation on their ability to perform their vital professional functions." *Id.* at 12.

Under the decision below, an analyst who receives allegations of fraud is placed in an impossible position which will discourage analysts from investigating such allegations. He can ignore the allegations, perhaps allow-

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conversation early in Dirks' investigation with a firm that *did* own Equity Funding stock. A few days later Dirks conveyed the full allegations to that firm. (*In re Boston Company Institutional Investors, Inc., et al.*, slip opinion, at 89, 95-96, 101; [1978] Fed. Sec. L. Rep. (CCH) ¶ 81,705, at 80,842, 80,844, 80,845.)

ing his clients to be further defrauded and violating the duty he owes to them. He can report the allegations to the regulatory agencies and do nothing more, a course of dubious efficacy in a situation such as Equity Funding where, as Dirks had been told, the allegations had already been reported to the regulators over a period of years and they had failed to act. Or he can do what Dirks did: attempt to publicize the situation in the only way open to analysts, by informing the press and other members of the securities industry, and thereby risk prosecution.

Thus, as *The Wall Street Journal* concluded from discussions of this case with members of the investment community shortly after the Initial Decision in this case was announced, "the analyst and investment firm appear caught between a rock and a hard place." Lynch, *Security Analysis and the Law, The Wall Street Journal*, at 22:4 (Sept. 15, 1978). The likely result will be that analysts will indeed follow the counsel of the SEC's attorney who at oral argument before the Commission baldly stated that when Dirks learned of the allegations of fraud at Equity Funding he should have done "nothing." The effect will be to shield companies from any independent probing that might uncover misconduct.

The SEC contends that analysts do not need the type of information received by Petitioner on the ground that financial analysts have disclaimed the need for "inside information." (Opp. Br. at 10 n.10) Of course, analysts have no need for "inside" information—information relevant to a corporate purpose—since such information can normally be expected ultimately to be disclosed to the public or reflected in the company's financial statements. But allegations about criminal fraud denied by manage-

ment are not "inside information"[3] and will *never* be publicized by the company or reflected in the company's financial statements. An analyst cannot provide a meaningful evaluation of a company if he relies only on statements by management, and insists on shielding himself from information about possible fraud. As one attorney quoted in the *Journal* article put it, "[p]erhaps without realizing it, the SEC is on a course of stifling the accumulation of information that keeps management honest."

It is, therefore, apparent that encouraging receipt of such information by analysts, and allowing recipients to disseminate it to others in the market, has important public benefits. As numerous commentators have correctly pointed out, it was only Dirks' action in spreading the story through the market and the reaction of the market to the story that led to the ultimate awakening of the regulatory agencies to the fact that something was wrong at Equity Funding. *See* H. Kripke, *The SEC and Corporate Disclosure: Regulation in Search of a Purpose*

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[3] Throughout its brief, the SEC persists in improperly labeling what Dirks received as "inside" information. (*E.g.*, Opp. Br. at 13 and 10 n. 10) But as the Solicitor General unequivocally points out, the information Dirks obtained "was not 'inside' information or any other form of 'confidential' information." (Opp. Br. at 17 n.*)

It is well established that inside information is "confidential information intended to be available only for a corporate purpose and not for the personal benefit of anyone." *Feldman* v. *Simkins Industries, Inc.*, 679 F.2d 1299, 1304 (9th Cir. 1982); *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961). As one commentator on this case has observed, "[i]nformation relating to a gigantic corporate fraud upon others can scarcely be considered a corporate asset or as having a valid corporate purpose." Heller, *Chiarella, SEC Rule 14e-3 and Dirks: "Fairness" versus Economic Theory*, 37 Bus. Law. 517, 548 (1982).

295 (1979); Heller, *Chiarella, SEC Rule 14e-3 and Dirks: "Fairness" Versus Economic Theory, supra*, at 549-50; Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information, supra*, at 337. As noted, the result was the end of the fraud and the conviction of the perpetrators.

It is these very benefits of Dirks' actions, and the chilling effect the decision below will have on others in his position, that have prompted the Solicitor General to warn that the decisions below will have a potential adverse effect on federal criminal law enforcement. (Opp. Br. at 18 n.*.) If the decision below is not reversed, and if it is not made clear to analysts and others who may receive information of possible corporate crimes that they may investigate and disseminate and share that information, those who receive such information will do what the SEC staff recommended Dirks should have done—"nothing"—and the SEC's claim that this is a "once-in-a-lifetime case" will unfortunately become a self-fulfilling prophecy.

CONCLUSION

For the foregoing reasons, and for the reasons stated in the Petition, the Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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